Principles of Federal Government Support for Microenterprise Development

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The US experience with microenterprise lending and training programs began in the early 1980s, and has grown rapidly. These programs which lend small amounts of capital (generally less than $25,000), often coupled with basic business management training and technical assistance programs, have tapped into a previously overlooked source of economic vitality.

Many agencies of the federal government support microenterprises, usually by funding nonprofit microenterprise development institutions (MDIs), that in turn serve microentrepreneurs with loans and technical assistance. Funding is currently available from the Small Business Administration; the Community Development Financial Institutions Fund, Department of the Treasury; the Economic Development Administration, Department of Commerce; the Department of Agriculture; the Office of Community Services, and Office of Refugee Resettlement, Department of Health and Human Services; Community Development Block Grants, Department of Housing and Urban Development; and Department of Labor.

The initial pilot demonstrations have inspired many organizations, new and existing, to adopt microenterprise development strategies as a means of helping people who generally cannot fully access traditional sources of capital and business assistance to help themselves. In the U.S., these microentrepreneurs exist in diverse communities, ranging from urban ghettoes to remote rural locations. The goal of microenterprise development strategies is to foster economic activity at a local, small-scale, indigenous level that benefits individuals in these communities.

The emergence of the microenterprise development field is also part of a broader trend, both among practitioners and policymakers, towards community-based economic revitalization. At the same time, microenterprise development strategies must forge a connection to mainstream financial markets to reach their full potential. Fully achieving this potential requires energizing an interdependent set of relationships:

(1) communities should seek to build vibrant local economies and markets in which microentrepreneurs can fully participate,
(2) intermediaries and financial institutions should be actively involved in ensuring that appropriate capital and technical assistance are available; and
(3) the federal government should be a useful catalyst, promoter, convener, and, to the extent possible, a funder that facilitates the private-sector delivery system for this sector.

This policy statement is the result of the discussions and deliberations of the Inter-Agency Microenterprise Task Force established by Presidential Executive Memorandum dated August 28, 1995.

This policy statement discusses the context for U.S. micoenterprise; the policy goals of microenterprise; how to deliver services to microentrepreneurs; microentrepreneurs' need for technical assistance;

financial objectives and internal operations of MDIs; and building the capacity of U.S. microenterprise development institutions. The paper concludes with general principles of federal government support for microenterprise development programs and specific recommendations for agency programs.

The Context for US Microenterprise

While the first microenterprise lending pioneers worked in developing countries, microentrepreneurship has proven to be an important economic sector in the more developed U.S. economy as well. The success of microenterprise internationally suggests there may be important lessons for U.S. programs, even though the experience abroad is not directly transferable. The U.S. economy's access to low-cost goods and to an extensive distribution system present special challenges for microentrepreneurs and for U.S. microenterprise organizations. In some developing countries, communities separated by even a few miles are entirely different retail markets. The very different circumstances facing U.S. microentrepreneurs become clear by reflecting on specific cases: microentrepreneurs who grow garden vegetables compete against harvests from overseas and the Sacramento Valley; home-based seamstresses must compete against Italian designers, Irish woolens and mass production techniques; even shade-tree mechanics compete for customers against national franchises.

Despite these challenges, US microentrepreneurs succeed in many business niches. Successful U.S. microentrepreneurs include, for example, retailers in ethnic communities where consumers prefer specialized goods and a familiar shopping environment, artisans making hand-made craft items, sole proprietors providing personal or business services, and a variety of businesses in isolated communities with fewer products available (which may include both poor urban areas and rural areas). Microentrepreneurship may be full-time employment for those in poorer urban or rural communities, or it may be a part-time income supplement.

Policy Goals of Microenterprise Programs

Microenterprise strategies help individuals combine their own knowledge, determination and start-up capital, with small loans and/or technical advice to build a small business. The federal government reaches mircoentrepreneurs through its support of microenterprise development institutions (MDIs), which are private organizations that provide microloans and/or training to microentrepreneurs. Therefore, the network of services to support microentrepreneurs must be effective and efficient in order to help those individuals succeed.

U.S. microenterprise programs aim to serve individuals in diverse communities and circumstances. As a result, these programs appropriately serve a variety of policy objectives. Some programs target lower-income individuals by emphasizing how microenterprise can be a supplementary source of income, while other programs focus on creating a sole source of income for those transitioning from welfare. Microentrepreneurs' businesses can become stable sources of income. Other microentrepreneurs find, after running a business for awhile, that they prefer traditional employment. Other programs locate microenterprise in a broader context of an individual's life skills and self-esteem. These programs emphasize peer support groups, consumer financial literacy, and building up savings for other assets, such as first-time home purchases or post-secondary education. Still other programs pursue microenterprise strategies as a means of assuring the broadest participation in a vibrant local economy. Some programs find that microentrepreneurs create a surprising number of jobs. These are all viable policy goals, and the early track record suggests that microenterprise programs can promote these outcomes. However, despite the various objectives and outcomes, the field still lacks consistent performance indicators and impact measurements that are widely and uniformly applied.

As in any business venture, the strongest MDIs tailor services to a specific clientele, and design all their services with that population in mind. For example, MDIs customize their outreach and marketing efforts, loan products, and specific technical advice to account for different needs of target groups.

How to Deliver Services to Microentrepreneurs

Those MDIs with lending programs – by their very nature, with numerous small loans and often with multiple funding sources -- call for financial skills in money management. From the customer perspective, the best MDIs operate with the highest standards of fairness, clarity and speed in making lending decisions. Given the burgeoning number of MDIs and the variety of approaches being tested, the state-of-the-art will continue to evolve in the coming years.

MDIs have experimented with different methods for disbursing loans and offering business assistance and training. Some programs describe themselves as "credit-led," focusing predominantly on microlending; others self-identify as "training-led," with primary emphasis on classroom and one-on-one technical assistance, followed by referrals to possible lenders. Among the MDIs that do offer loans, some use individual lending (though with non-traditional underwriting methods and collateral requirements), and others adapt the models of peer group lending first used in developing countries.

Some programs are evolving due to increased technological capacity (making on-line banking possible for MDIs and ATM usage more prevalent for borrowers), increased experimentation with credit scoring as a way to streamline loan approvals, and increased use of partnerships with traditional financial institutions and other business resources. More MDIs may adopt these approaches in the future.

Microentrepreneurs' Need for Technical Assistance

In addition to loan capital, most microenterpreneurs also benefit enormously from technical assistance in running their businesses. Especially in the competitive and regulated U.S. marketplace, microentrepreneurs benefit from experienced small business advice. Although technical assistance is a critical service, there is less consensus on how best to provide cost-effective, immediately useful business advice.

The most useful business services include cash flow budgeting, basic bookeeping and tax preparation, business planning, help with loan applications, and simple marketing and advertising advice. Generally, these services are provided through one-on-one counseling, classroom sessions, or through peer group exchanges. Beyond these services, some U.S. programs have begun to explore how to provide microentrepreneurs with broader access to markets (new customers) and access to more industry-specific technical expertise. Access to markets may mean organizing local retail demand, such as in marketplaces, through catalogs, or on the Internet, or it may mean selling to corporate customers. Access to industry advice may come via trade groups or organized large firm-to-microenterprise linkages.

Financial Objectives and Internal Operations of MDIs

Although U.S. programs have not yet achieved the scale and per-borrower efficiencies necessary for financial self-sufficiency, several programs may be coming close. In the international setting, where the borrower and lender economics are quite different, several microenterprise programs are now covering their credit delivery costs with interest revenue. Achieving financial self-sufficiency is a sign of a strong MDI program, both in terms of customers' demand for the microloan services and in terms of disciplined financial management. Financial self-sufficiency also puts the program on more solid footing. Nonetheless, it is an enormous challenge to generate substantial revenue through small loans, and it is too early to know if this is a realistic goal for U.S. programs.

In their own cost accounting, MDIs are beginning to record their credit-program costs separately from their training and support costs. This allows the MDI to track loan performance rigorously (assuring that interest rates are sufficient to cover losses and operating costs), to monitor financial efficiency, and to isolate the training costs that may require ongoing financial subsidy, a practice consistent with international best practice.

As the U.S. microfinance field matures and expands, it becomes even more important to establish agreed-upon indicators of financial performance. Standard portfolio performance measures and impact measures would help the field share best practices, document success, and attract additional funding.

Building the Capacity of U.S. Microenterprise Development Institutions

The growth of the MDI industry creates a new role that calls for multi-disciplinary skills and experience. The lack of a large number of MDI managers with financial and managerial skills may be the most significant obstacle to expanding microenterprise services. As a rapidly expanding and evolving field, practitioners need to learn from best practices in this expanding field, both domestically and internationally. There need to be more organized efforts to cultivate the existing and future industry leaders. MDIs' top management may need training in particular business skills, financial management, administering social service programs, and how to measure impact. MDIs' field staff may require training in managing basic credit operations, such as lending skills and loan collection skills, or in training and counseling.

Microenterprise lenders face regular challenge of finding sufficient and reliable funding base so that they can concentrate efforts in the field and hire long-term skilled staff. Often, these program operators can find sources of loan capital (some with concessionary interest rates), but cannot find the equally essential support for professional development.

With the range of microenterprise programs in various federal agencies, there has inevitably been variation in evaluation, reporting and measurement criteria. Agencies should continuously look for opportunities to better coordinate its efforts to reduce the burden on MDIs.

Principles of Federal Government Support of Microenterprise Development

The Workgroup recommends that the principles guiding federal government's microenterprise policy should include:

- Recognize microenterprise development strategies as a valuable component of individual development and community economic revitalization. At the same time, microenterprise is only occasionally the single strategy that can help an individual achieve self-sufficiency. Government support for microenterprise efforts should be part of larger efforts toward community economic development and human capital development.

- Support a range of microenterprise programs as broad as the needs of microentrepreneurs themselves, and assess the programs accordingly.

- Encourage MDIs to target particular populations, understand their needs, and customize services, and use community business and service networks to help fill gaps or expand MDI capabilities.

- Take into consideration both the effectiveness of the services to the microentrepreneur, as well as the need to build the long-term financial health of the MDI that delivers the credit and services. The MDIs themselves must be strong to serve microentrepreneurs effectively.

- Encourage identification and adoption of industry best practices, tracking both impact on microentrepreneurs and the MDIs themselves. Government should expect continuous improvement from MDIs in delivering microenterprise development services and in outcomes for microentrepreneurs.

- Encourage MDIs to keep the goal of financial self-sustainability in their sights, both to lessen financial dependency and as a sign of high-quality loan programs. The government should stand ready to fund microfinance institutions that demonstrate increasing cost recovery for their credit operations. Technical assistance services and marketing and outreach may require subsidy, especially to reach the poorest populations, but should be accounted for separately on the books. The government programs should also take into account, perhaps with incentives, increased efficiency in providing business advice.

- Scale up the funding for successful MDIs, while encouraging experimentation and innovation among newly emerging programs as well. Scaling up the successful programs would not only expand their reach, it would improve efficiency in delivering services.

- Ensure funding for technical assistance to borrowers because it remains an essential component to reaching targeted underserved populations.

- Encourage MDIs to partner with mainstream financial institutions in order to tap the skills and expertise of both organizations: the MDIs' direct, hands-on assistance that is not easily replicated by larger, mainstream financial institutions, and the financial institutions' financial skills, branch delivery systems, and a broader product mix. Both types of institutions may benefit from closer collaborations.

- Consider creating a clearinghouse function for domestic microenterprise best practices.

Recommendations for Federal Microenterprise Programs

The Task Force recommends that the program agencies operating microenterprise programs should:

1. Articulate, before funding, both the desired MDI actions and the hoped-for outcomes for the microentrepreneur. Program agencies should urge practitioners to define their success measures, and then expect accountability for results, both programmatic and financial. Agencies should stimulate and support innovation, but not continue to fund programs that lack a clear program direction.

2. Use rigorous financial analysis in evaluating microenterprise programs, including tracking of loan losses and loan delinquencies with consistent definitions and standards. Because MDIs serve a different customer base often operating in distressed markets, other performance measures may also be appropriate, but without relaxing standards for high-quality data and for financial analysis of performance.

3. Encourage the field to develop and implement measures of the impact on microenterprise clients that can be compared across programs, even if the measurements continue to be refined over time.

4. Focus attention on training and technical assistance efforts to expand and build MDIs' capabilities, while continuing to provide loan capital to MDIs;

5. Encourage MDIs' exploration of methods for providing technical assistance, including various teaching methods and business-to-business partnerships that can best assist small borrowers.

6. Support the development of MDIs' internal performance measurements, including peer comparisons

as benchmarks. These standards should include financial benchmarks as well as institutional development best practices, such as strong and capable boards of directors.

7. Encourage MDIs' to include computer and Internet training where appropriate for the business owners' success.

8. Seek consistency in reporting and evaluation criteria across different federal agencies.

9. Adopt the most streamlined reporting procedures possible for MDIs, including on-line submission of reporting data.